In the Supreme Court

OF THE

United States

OCTOBER TERM, 1974

No. ...74...

CUBIC CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JAMES O. HEWITT
RICHARD A. SHAW
ANTON DIMITROFF

HEWITT & SHAW
1010 Second Avenue
San Diego, California
Tel: (714) 239-2121

Attorneys for Petitioner

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Petitioner prays that a Writ of Certiorari issue to review an opinion and order of the United States Court of Appeals for the Ninth Circuit affirming the judgment of the United States District Court of the Southern District of California.

OPINIONS BELOW

The memorandum opinion of the Court of Appeals, not yet officially reported, is set forth herein as Appendix A, *infra,* pp. 1a-2a. The Findings of Fact and Conclusions of Law of the United States District Court is reported at Fed. Supp. (S.D. Calif. 1971), 72-1 U.S.T.C. ¶9165 (1971), 28 AFTR 2d 71-6105 (1971) and set forth herein as Appendix B, *infra,* pp. 1b-10b. The judgment of the United States District Court is set forth herein in Appendix B, *infra,* p. 11b.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on March 12, 1974. Petitioner filed a combined petition for rehearing and suggestion that rehearing be in banc. On May 2, 1974, the Court of Appeals entered its order denying the petition for rehearing and rejected the suggestion for a rehearing in banc (Appendix A, *infra,* p. 3a). The jurisdiction of this Court is invoked under 25 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Important Question of Federal Law

Should United States ownership of an irrevocable non-exclusive royalty-free license in a government contractor's invention preclude the contractor from obtaining capital gains tax treatment on the subsequent sale of the invention even though (1) the contractor sells all substantial rights then owned by the contractor and even though (2) the imposition of an ordinary income tax would have an adverse impact on the public policy encouraging discovery and invention enunciated in Article I, Section 8 of the

Constitution? Should not the [illegible] in denying capital gain treatment [illegible] tion, based on pre-existing rights [illegible] States, be reviewed by this Court to resolve a conflict in this decision with decisions of the [illegible] Fourth Circuit, the Court of Claims and the [illegible]

2. Conflict with Supreme Court Decision

In determining that there was [illegible] stantial rights to an inventor [illegible] activities of the taxpayer [illegible] exclusive geographical territory [illegible] sold. Should not the Ninth [illegible] of this Court in recognizing that [illegible] may legally be made to a specific [illegible]

3. Conflict of Decision in Courts of Appeal

Should not the Ninth Circuit apply [illegible] test used by the Third Circuit, the Fourth Circuit, the Court of Claims in determining [illegible] right in the exclusive territory [illegible]

CONSTITUTIONAL PROVISION INVOLVED

Article I, Section 8, Clause 8 of the Constitution states that the Congress shall have the power to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.

STATEMENT OF THE CASE

I. FACTUAL BACKGROUND

The Petitioner, Cubic Corporation, is a California corporation which is engaged in the business of precision electronic distance measuring equipment [illegible]

and angle measuring equipment (AME) which were utilized as components in missile tracking systems. Both the DME and AME were developed under research and development contracts with the United States, and pursuant to applicable federal law and regulations the United States retained irrevocable, non-exclusive royalty-free licenses in the inventions.

The French Government became interested in obtaining electronic tracking devices from the taxpayer and during the years 1958 through 1960, various representatives of the French Government corresponded with taxpayer, obtained general technical materials from taxpayer concerning its tracking devices, and visited taxpayer's plant in San Diego, California. Rather than purchase the tracking equipment directly from taxpayer, the French Government decided that such equipment should be acquired from a French company which would manufacture the equipment in France under a license from taxpayer. The French company ultimately selected to enter into the license agreement with taxpayer was Compagnie des Compteurs (CdC).

On or about August 5, 1960, taxpayer and CdC entered into an agreement whereby taxpayer sold to CdC the exclusive right to manufacture, use, distribute, and sell the subject products in an exclusive territory geographically limited to France and certain other countries or territories associated with France. For such rights, CdC agreed to make an immediate cash payment and to pay a percentage royalty based upon sales of products manufactured and sold pursuant to the Agreement.

Taxpayer reported the cash payment and royalty payments for the exclusive license received pursuant to the Agreement as long-term capital gains on the applicable Federal income tax returns for the years 1960-1963.

For purposes of this petition the pertinent part of the Agreement was the provision in Article 1.4 which stated:

> 1.4 *Sales To United States Government*
>
> LICENSOR (taxpayer) reserves the right to conduct business with all agencies of the United States Government in all parts of the world for any reason.
>
> If it becomes a possibility that LICENSEE (CdC) can make an offer to an Agency of the United States Goverment not using "Off Shore Funds", LICENSEE shall, in such case obtain prior authority to conduct such business by applying for this authority to LICENSOR.
>
> In the case of the use of "Off Shore Funds" by Agencies of the United States Government for procurement within the exclusive or non-exclusive territory of LICENSEE, LICENSEE does not require prior authority from LICENSOR to compete for this business, but LICENSEE will advise LICENSOR as soon as possible of the imminence of such business. LICENSOR will encourage Agencies of the United States Government to make "Off Shore Procurements" directly from LICENSEE if they fall within its exclusive territory.

Under this clause the right of the taxpayer to sell the invention to the United States in the French territories was limited by the language which required the taxpayer to

*The term "off shore funds" means any appropriated funds used for government purchases for use overseas. Pasley, "Offshore Procurement" U.S. Dept. of Army Pamphlet No. 27-100-18, *Military Law Review* 55 (1962); U.S. Dept. of Army Pamphlet No. 27-153, *Procurement Law* 265 (1961). Thus, the reference to an offer not using "off shore funds" in this sentence in the agreement with CdC required consent for an offer to sell to the United States for use in the geographical United States.

encourage the United States to make any purchases in the exclusive territory from CdC. Under the contract the only way the taxpayer might have sold any of the invented properties to the United States in the exclusive French territories was if the United States exercised its royalty-free license in the invention and rejected taxpayer's obligation to encourage the United States to purchase from the French Company, CdC. The taxpayer did not intend to sell and did not sell to the United States any of the invented properties for use in the exclusive French territory. The clause was not negotiated but was included in the contract because taxpayer was required by the United States to disclose and preserve pre-existing government rights to the inventions.

II. PROCEEDINGS BELOW

The Commissioner of Internal Revenue determined that income received by the taxpayer in the years 1960-1963 pursuant to the agreement with the French Company was taxable at ordinary income rates rather than at capital gain rates. Taxpayer paid the deficiency assessed and filed timely claims for refund with the Internal Revenue Service. On March 17, 1967, the taxpayer timely filed a suit for refund in the amount of $155,746.16 for taxes improperly paid, plus interest, in the United States District Court for the Southern District of California under jurisdiction authorized in 28 U.S.C. §1346(a)(1) and §1402(a)(2), and 26 U.S.C. 7422 and the Internal Revenue laws of the United States. The district court held that "there was a transfer of something less than all of the substantial rights" in the property conveyed under the French agreement and therefore the Commissioner correctly determined that the proceeds should have been reported as ordinary income. Judgment was entered for the United States on December

20, 1971. On appeal to United States Circuit Court of Appeals for the Ninth Circuit, the judgment of the district court was affirmed on March 12, 1974. The Court of Appeals held that the retention by the taxpayer of the right to use the invention in sales to agencies of the United States Government was the retention of a "substantial right" to the invention and that the income from the transfer did not qualify for capital gain treatment. The Court of Appeals in its opinion failed to consider the absence of economic significance in the right and failed to take into account the fact that there were no sales to the United States in the geographically limited French exclusive territories and that there was no intent to make such sales.

REASONS FOR GRANTING THE WRIT

I. IMPORTANT QUESTION OF FEDERAL LAW

THE NINTH CIRCUIT HAS RAISED AN IMPORTANT QUESTION OF FEDERAL LAW, NOT PREVIOUSLY DETERMINED BY THIS COURT, BY IMPROPERLY HOLDING THAT THE UNITED STATES OWNERSHIP OF AN IRREVOCABLE ROYALTY-FREE LICENSE IN A GOVERNMENT CONTRACTOR'S INVENTION WILL PRECLUDE THE CONTRACTOR FROM OBTAINING CAPITAL GAINS TREATMENT ON THE SUBSEQUENT SALE OF ALL SUBSTANTIAL RIGHTS IN THE INVENTION THEN OWNED BY THE CONTRACTOR. THE DECISION OF THE NINTH CIRCUIT IS IN CONFLICT WITH DECISIONS IN THE SECOND CIRCUIT, THE FOURTH CIRCUIT, THE COURT OF CLAIMS AND THE TAX COURT AND IS ALSO INCONSISTENT WITH THE PUBLIC POLICY TO PROMOTE DISCOVERY AND INVENTION ENUNCIATED IN ARTICLE I, SECTION 8 OF THE CONSTITUTION.

When the subject inventions were initially created by the taxpayer under government research and development contracts, the United States became the owner of irrevocable non-exclusive, non-transferable royalty-free licenses

to practice the manufacture, use and disposition of the inventions throughout the world, under applicable federal law and regulations.

In accordance with governmental regulations requiring disclosure, the government clause in the license agreement with CdC recognized this pre-existing right of the United States to conduct business with the taxpayer, but also obligated the taxpayer to encourage the United States to deal with CdC, if the United States contemplated a purchase for overseas use ("off shore funds") in the exclusive French territory.

The lower court in effect held that this right of the United States under the royalty-free license to deal with the invention throughout the world was legally the retention of a substantial right by the taxpayer.

The pre-existing right in the United States created at the time of invention was a separate and distinct right from the bundle of rights created for the taxpayer. It was a right which the taxpayer never possessed. Although the taxpayer never owned the rights preserved by the United States, the taxpayer, at least, sold all of the substantial rights which it owned at the time of the sale. The lower court decision in denying capital gain treatment based on rights owned by a third person, the United States, is in conflict with decisions in the Second Circuit, the Fourth Circuit, the Court of Claims and the Tax Court which require only that the taxpayer transfer all substantial rights owned by him at the time of sale.

In *Bell Intercontinental Corporation* v. *United States*, 381 F. 2d 1004 (Ct. Cl. 1967), the court held that the taxpayer's sale of an exclusive license of a patented aircraft invention constituted a capital gain transaction, even though the license was expressly subject to a cross-

licensing agreement of the Manufacturers Aircraft Association. This cross-licensing agreement required the taxpayer to make all its patented aircraft inventions available to all other MAA members for use on their own aircraft and to grant all other members non-exclusive royalty-bearing licenses of the patents. The court held the MAA agreement was merely "a previously imposed limitation upon, not a reserved right to, the invention."

In *Donald C. MacDonald*, 55 T.C. 840 (1971), *Acq.* 1973-2 Cum. Bull. 5, the taxpayers were assignees of certain patents which were subject to prior non-exclusive licenses granted by the assignor. The taxpayers then sold all their rights in the patents. The Commissioner argued that "all substantial rights" means all the original patent rights and that a transfer of all remaining rights (the taxpayers' rights being subject to prior non-exclusive licenses) would not qualify for capital gains. The Tax Court rejected this argument, holding that the taxpayers were entitled to capital gain treatment since they "transferred 100 percent of any patent rights which they *ever* held". Id. at 859.

In *Rollman* v. *Commissioner*, 244 F. 2d 634 (4th Cir. 1957) the license agreement was treated as a sale notwithstanding that it was apparently subject to two existing non-exclusive licenses previously granted.

In *General Aniline & Film Corp.* v. *Commissioner*, 139 F. 2d 759 (2nd Cir. 1944), where the contract subjected the present assignment to all prior commitments, including certain exclusive obligations to various named corporations, the court summarily dismissed the prior grant of some rights to others, as not important in determining the present transfer of ownership for taxation purposes.*

*Judge Frank, who wrote the opinion, made further consistent comment about this decision in *Rohmer* v. *Commissioner* 153 F. 2d 61, 64 (2d Cir. 1946).

By holding that a government contractor, the taxpayer, cannot transfer all substantial rights to an invention because of its pre-existing obligation to do business with the United States under the royalty-free license reserved by the United States, the lower court has in effect held that persons who create inventions under government research and development contracts are not entitled to capital gains treatment upon the sale of their inventions even though they have sold all they own. This is patently discriminatory and is in conflict with public policy.

The Constitution in Article I, Section 8, in authorizing Congress to give exclusive rights to inventors, recognized the importance of discovery to our American heritage. Congress, in protecting capital gain treatment for individual inventors in Section 1235 of the Internal Revenue Code, 26 U.S.C. §1235, explained that its purpose was ". . . to provide an incentive to inventors to contribute to the Welfare of the Nation . . ." S. Rep. No. 1622, 83rd Cong. 2d Sess. 438, 439 (1954). The present decision of the court has the effect of undermining the public policy expressed by these basic principles.

This Court aptly demonstrated how the Ninth Circuit's decision in this patent tax case conflicts with the public policy of the United States when it stated:

> "the settled purpose of the United States has ever been, and continues to be, to confer on the authors of useful inventions an exclusive right in their inventions for the time mentioned in their patent. It is the reward stipulated for the advantages derived by the public for the exertions of the individual, and is intended as a stimulus to those exertions. The laws which are

passed to give effect to this purpose ought, we think, to be construed in the spirit in which they have been made; and to execute the contract fairly on the part of the United States, where the full benefit has been actually received; if this can be done without transcending the intention of the whole statute, or countenancing acts which are fraudulent or may prove mischievous. The public yields nothing which it has not agreed to yield; it receives all which it has contracted to receive. The full benefit of the discovery, after its enjoyment by the discoverer for fourteen years, is preserved; and for his exclusive enjoyment of it during that time the public faith is pledged." *Grant* v. *Raymond*, 31 U.S. 218, 6 Pet. 218, 240, 8 L.Ed. 376 (1832).

In erroneously treating a pre-existing government right as the reservation by the taxpayer of a substantial right, the Ninth Circuit destroys a vital incentive for the stimulation of creative ingenuity in government contracting. *First*, the Constitution and the Congress encourage invention; *second*, the government takes a royalty-free license to promote the development of United States technology, but leaves title in the hands of the inventor in order that he can exploit it in private industry, and *finally*, the holding of the lower court takes away the economic incentive to the taxpayer because he unfortunately developed the invention under a United States contract instead of on his own. The court has effectively cut off the right to capital gain treatment for all private contractors who develop inventions in dealing with the Department of Defense or other Government agencies. This holding must have a detrimental impact on potential inventors who believe

private exploitation opportunities are greater than public governmental opportunities. In the past, they could utilize both. In the future, they must weight the potential economic tax cost of allowing the government to take a license against the tax savings of remaining in solely private industry.

The seriousness of the potential adverse impact upon future research and development by United States Government contractors merits this Court taking its valuable time to examine the question of whether the government's royalty-free license limitation should be disregarded in measuring substantial rights retained by the taxpayer.

II. CONFLICT WITH SUPREME COURT DECISION

THE NINTH CIRCUIT IMPROPERLY EXAMINED ACTIVITIES OF THE TAXPAYER OUTSIDE OF THE GEOGRAPHICALLY LIMITED EXCLUSIVE FRENCH TERRITORY IN DETERMINING WHETHER THERE WAS A TRANSFER OF ALL SUBSTANTIAL RIGHTS, THEREBY CREATING A CONFLICT BETWEEN THE NINTH CIRCUIT AND THIS COURT AND THE TAX COURT.

This Court in *Waterman* v. *MacKinzie,* 138 U.S. 252 (1891), has specifically held that there may be a valid assignment of exclusive patent rights limited to a specific geographical area. This Court has applied the following test for determining whether there has been the sale of a patent:

> "The monopoly thus granted is one entire thing, and cannot be divided into parts, except as authorized by those laws. The patentee or his assigns may, by instrument in writing, assign, grant and convey, either 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the

> United States; or, 2d, an undivided part or share of that exclusive right; or, 3d, *the exclusive right under the patent within and throughout a specified part of the United States.* Rev. Stat. §4898. A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself . . ." Id. at 255 (italics added).

Although the case was concerned with infringement of patent rights rather than taxation, the above quotation has been repeatedly quoted as the basis for the courts allowing capital gain on the transfer of all substantial rights to an invention within a geographical area.

Significantly, the Ninth Circuit, in *United States* v. *Carruthers,* 219 F. 2d 21 (9th Cir. 1955), a tax case, relied upon *Waterman* v. *MacKinzie, Supra,* in unqualifiedly stating that: "Clearly, the transfer can be limited in area." In the present case the Ninth Circuit completely ignored its earlier discussion on geographical areas and on *Waterman,* without giving either qualification or explanation.

The United States Tax Court has consistently recognized that the sale of an exclusive right to manufacture, use and sell an invention limited to a geographical area is a sale taxable at capital gain rates. *Estate of George T. Klein,* 61 T.C. 332 (1974) (geographical area, 14 States); *Vincent B. Rodgers,* 51 T.C. 927 (1969) (geographical area, City of Merced, California); *Vincent A. Marco,* 25 T.C. 544 (1955) (geographical area, Western United States).

Since capital gain treatment is allowable on the sale of an exclusive license to a geographically limited area the inquiry as to whether all substantial rights have been transferred by the taxpayer must, *a fortiori,* be restricted to

an examination of rights affecting only the French exclusive territory.

The lower court improperly looked to the activities of the taxpayer in making sales to the United States *outside* of the exclusive French territories in determining that a substantial right was retained *in* the exclusive territory. The only factual information relied upon by the court in treating the government clause as a substantial right was the following:

> "The Federal Government was Cubic's largest customer at the time, much of its work involving military agencies and the tracking system for Project Mercury. The District Court found that this was the retention of a "substantial right" to the invention and that the income from the transfer did not qualify for capital gain treatment. We agree."

During the period from 1960 to 1964 the taxpayer made 26 sales of the invented properties, of which 19 were made to the United States. All 19 sales were made to agencies of the United States *within the geographical limits of the continental United States.* The geographical United States was not a part of the licensed territory and sales within the United States or within any other country outside of the geographical confines of the exclusive French territory were not relevant to the issue at hand. If A owns Blackacre and sells an undivided one-half interest to the United States, that fact does not prevent A from obtaining capital gain on the sale of the other undivided one-half interest in Blackacre to a French company.

The type of property sold by taxpayer to the United States for Project Mercury and referred to by the lower

courts was not even part of the inventions sold to CdC in the 1960 agreement.

An examination of the entire government clause, as applied solely to the exclusive territory necessitates a conclusion that no right was reserved by taxpayer with respect to the United States in the exclusive territory. Under the clause, the licensee, CdC, was authorized to make sales to the United States in the exclusive territory without any consent from taxpayer. The taxpayer was *required* to encourage the United States to make any purchases in the exclusive territory from CdC. Any attempt by the taxpayer to initiate a sale to the United States in the exclusive territory would have been unlawful breach of the contract. The only way in which the taxpayer might have sold any of the subject products to the United States in the exclusive territory was if the United States exercised its royalty-free license in the invention and rejected taxpayer's efforts to encourage the United States to purchase from CdC. The royalty-free license was a pre-existing right belonging to the United States, not the taxpayer.

In refusing to treat a transfer of the exclusive right to the invention within an exclusive geographical territory as a sale, the Ninth Circuit has created a conflict with the decision of this Court in *Waterman* v. *MacKinzie, supra* and with the Tax Court. The conflict is one which should be resolved by this Court.

III. CONFLICT OF DECISION IN COURTS OF APPEAL

THE REFUSAL OF THE NINTH COURT TO APPLY THE ECONOMIC VALUE TEST IN DETERMINING WHETHER THE GOVERNMENT RIGHT IN THE EXCLUSIVE TERRITORY WAS A "SUBSTANTIAL" RIGHT CREATES A CONFLICT WITH THE THIRD CIRCUIT, THE FOURTH CIRCUIT AND THE COURT OF CLAIMS.

The Ninth Circuit held that the government right was the retention of a substantial right without giving any consideration to the lack of economic value in the right within the exclusive French territory. This is in direct conflict with the Third Circuit and Fourth Circuit which require not only the retention of a right but also evidence that the right is of "substantial" value. In *E. I. du Pont de Nemours & Co.* v. *United States*, 432 F. 2d 1052 (3rd Cir. 1970), *aff'g on patent issue*, 296 F. Supp. 823 (D.C. Del. 1969), a domestic licensor granted an exclusive license to a Brazilian company but reserved the right to import the subject products into Brazil. The court held that the reservation of the import right was not a "substantial" right unless it had substantial value. It concluded that the import right of the licensor to compete in the exclusive territory was not a substantial right because the practice of the Brazilian Government to forbid competition from foreign suppliers once a domestic company began production, was known to the parties, they considered the right inconsequential, and the right was not subject to negotiation. The right was held unconsequential even though some imports were made by the licensor for four years. The Fourth Circuit in *Rollman v. Commissioner*, 244 F. 2d 634 (4th Cir. 1957) held the retained right of the licensor to use patents for footwear construction in an exclusive territory was not of substantial value under the circumstances. In *Bell Intercontinental Corp. v. United States*, 381 F. 2d 1004 (Ct. Cl. 1967) the court found the retention of right of the licensor to manufacture an anti-shimmy device for its own use to be "so unsubstantial as to be of little tangible value".

The undisputed facts in this case are that taxpayer had no intention to sell to the United States in the exclusive territory, that taxpayer made no sale to the United States

in the exclusive territory, and that the status was not a subject of negotiation, but was included because of the royalty-free license. In addition, the taxpayer had no contractual right to even initiate negotiations with the United States in the exclusive French territories.

If the lower court had applied the economic realities test to the government right as required by the Third and Fifth Circuits the only rational conclusion is that the right was not a substantial right in the transaction. The result reached by the Ninth Circuit is at odds with established law and establishes confusing precedent. The conflict is one that should be resolved by this Court.

CONCLUSION

For the foregoing reasons, the petition for a Writ of Certiorari should be granted.

Respectfully submitted,

James O. Hewitt
Richard A. Sears
Anton Dworkowitz

Hewitt & Sears
1010 Second Avenue
San Diego, California 92101

Counsel for Petitioners

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

CUBIC CORPORATION, a California corporation, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *Defandant-Appellee.*	No. 72-1940 MEMORANDUM

Appeal from the United States District Court for the Southern District of California

Before: CARTER and WRIGHT, Circuit Judges, and LUCAS, District Judge*

The appellant taxpayer appeals from a finding and judgment that royalties and other income from the transfer of "know how" rights to its invention did not qualify for capital gain treatment. We affirm.

In 1960, taxpayer granted a French corporation a license to manufacture electronic tracking equipment invented by taxpayer. The parties agree that taxpayer's income from the transfer qualifies for capital gain treatment only if "all substantial rights" to the invention were transferred to grantee.[1]

*Of the Central District of California.

[1]Int. Rev. Code § 1235 provides for capital gain treatment of patent royalties if "all substantial rights" to the patent have been transferred. Section 1235 does not directly apply to this case because the taxpayer is a corporation, E.I. dul'ont de Nemours & Co. v. United States, 432 F.2d 1052, 1054 n.2 (3rd Cir. 1970), and because the transfer was of "know how" rather than patent rights. But the same "all substantial rights" standard has been independently applied to corporate taxpayers, *id.*, and to grants of "know how." Pickren v. United States, 378 F.2d 595 (5th Cir. 1967).

Taxpayer retained the right to use the invention in its sales to agencies of the United States government. The federal government was Cubic's largest customer at the time, much of its work involving military agencies and the tracking system for Project Mercury, the district court found that this was the retention of a "substantial right" to the invention and that the income from the transfer did not qualify for capital gain treatment. We agree.

The judgment of the district court is affirmed.

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

CUBIC CORPORATION, a California corporation, *Plaintiff-Appellant,* vs. UNITED STATES OF AMERICA, *Defendant-Appellee.*	No. 72-1940 DC #67-61-C (RES) ORDER

Before: CARTER and WRIGHT, Circuit Judges, and LUCAS, District Judge.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for an en banc hearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

DATED: May 2, 1974

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

CUBIC CORPORATION, a California corporation, *Plaintiff*, vs. UNITED STATES OF AMERICA, *Defendant*.	Civil No. 67-61-C FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Court finds:

I.

This is an action for the refund of income taxes paid by plaintiff and alleged to have been erroneously assessed and collected. Plaintiff properly claimed the refunds sought and is now properly before the Court.

II.

Cubic Corporation (Cubic) is a California corporation, engaged primarily in the business of developing and manufacturing electronic equipment. It developed among other things angle measuring equipment (AME) and distance measuring equipment (DME) useful in various combinations in the tracking of missiles and satellites. Application for patents had been made with respect to such equipment. AME and DME systems were sold to various agencies of the United States interested in missile and satellite tracking.

III.

In 1958 the French government, concerned with the instrumentation of its missile range in Algeria, became interested in the AME and DME equipment, investigated it, and in 1960 approved it for use. The French were willing to buy some equipment from Cubic but wanted some of the equipment manufactured domestically and approved certain French companies as potential manufacturers. One of these was Compagnie des Compteurs (CdC). Cubic, which had been trying to sell the French, believed that a sale depended upon the licensing of a French company to manufacture its equipment. Cubic granted a license to Cubic S.A., a wholly owned foreign subsidiary, which assigned it to CdC. The parties agree that so far as this case is concerned nothing turns on the intervention of Cubic S.A. and for convenience these findings refer only to Cubic.

IV.

In June 1960 Cubic offered to sell one DME and two AME systems and related equipment to CdC at a quoted price contingent, however, on the conclusion of a license agreement between the parties. Two written contracts (Ex. 45 and 34) (plus some amendments) resulted from the negotiations, but the contracts were contingent on each other and together with the amendments form the agreement of the parties.

V.

In August 1960 an agreement (Ex. 34) was executed. It granted to CdC the exclusive right to manufacture and use, distribute, and sell the "subject products," describing them as COTAR, SECOR, MOPTAR, MIDAS, and Correlative Techniques (basicaly the AME and DME equip-

ment plus modifications, developments, and improvements) in an exclusive territory, and the right to use, distribute, and sell them in a nonexclusive territory. The exclusive territory was France and the territories in which France had some special interest. The nonexclusive territory was the rest of the world except the United States, Canada, and Italy. Applications for patents for COTAR, SECOR, MOPTAR, and MIDAS were on file as of the license date, and patents were later granted. No applications for registry in France were made and as to all patents except MOPTAR the priority period fixed by Art. 4 C(1) by the International Convention for the Protection of Industrial Property, June 27, 1935, 47 Stat. 1789 (1935), had expired at the time of the license.

The term of the agreement was for the useful life of the designs, design rights, and patents, subject, however, to termination on breach of any material provision by the licensee.

Cubic agreed that CdC should have access to all available product information and "know how" and that it would furnish a complete spectrum of the technical data prepared or used by it in the manufacture of the subject products and would give in-plant training to three of CdC's people per year. On request Cubic was to furnish other technical assistance at CdC's cost. No such requests for assistance were made.

VI.

The licensing agreement contains provisions in the nature of restrictions or limitations as follows:

1.4 — *Sales to United States Government.*

LICENSOR reserves the right to conduct business with all agencies of the United States Government in all parts of the world for any reason. . . .

1.8 — *Notice of License.*

LICENSEE shall cause to be attached to, or imprinted upon each product manufactured by LICENSEE under this Agreement, an appropriate inscription setting forth in English. or in English and any other language which LICENSEE may elect to use, that such product was manufactured by LICENSEE under license from LICENSOR.

• • •

6.5 — *Registration.*

LICENSEE agrees that, during the period of this Agreement it will, at its own expense, maintain and duly register, in the name of LICENSOR, both in the exclusive and non-exclusive territories where LICENSEE shall have manufactured and/or sold subject products, all patents taken out by LICENSOR in any other country deemed necessary by LICENSOR to the continued manufacture of the subject products ....

• • •

8.4 — *Return of Technical Data.*

Upon termination of this Agreement, by lapse of time or otherwise, LICENSEE shall forthwith return to LICENSOR at LICENSEE'S expense, all technical data theretofore furnished to LICENSEE under or in connection with the Agreement, provided that LI-

CENSEE may thereafter execute the orders for subject products which it has received before termination in accordance with the provisions of the present Agreement which would have been applicable had this Agreement not been terminated.

• • •

10.2 — *Reproduction of Data.*

LICENSEE covenants and agrees that none of the technical data or information supplied to it hereunder or in connection herewith, or copies thereof, shall be used or reproduced by LICENSEE for purposes other than strictly in connection with the manufacture, assembly, modification, and overhaul thereof. Upon the sale or other transfer of any subject product, the instrument of sale or transfer may permit the use of such data and information to the extent necessarily required by the purchaser or transferee in the operation, maintenance and overhaul thereof, but each such instrument shall limit the right and privilege of the use of such data and information to the purposes aforesaid and shall preserve LICENSOR the right to enforce such limitation.

10.3 — *Confidential Treatment.*

All such technical data and information (except such as may be of common knowledge in the industry as of the date hereof) shall be treated as confidential by LICENSEE and its officers, agents, and employees.

VII.

The contract did not restrict the license to the production of the subject products for missile and satellite appli-

cations. The contract did in several places describe the equipment as being used in those fields but there is nothing in the contract to indicate that CdC could not sell to any otherwise proper purchaser who wanted the equipment for any purpose.

VIII.

The price agreed upon for the manufacturing rights granted by the license was $275,000.00. A seven and one-half percent royalty on all subject products manufactured and sold by CdC was provided, but the agreement did not specifically allocate the royalty as payment for the manufacturing rights. The $275,000.00 was reduced to $200,000.00 in consideration of the purchase by CdC of $700,000.00 worth of equipment to fulfill the initial requirements of the Algerian Missile Range.

IX.

The license which had been granted by Cubic to Officine Toscane Electromeccanice, an Italian corporation, did not limit or impair the rights granted to CdC under the license agreement.

X.

The license agreement was amended three times: once on February 28, 1962, by the addition of rights to additional tracking devices, AGAVE and AERIS (the patent application for AGAVE was filed in 1959 and priority rights under the Convention had expired; the patent application for AERIS was not filed until April, 1962); a second time on November 6, 1962, by the enlargement of the exclusive territory and a promise by CdC to pay $150,000.00; and a third time on April 29, 1963, by the reduction of the

$150,000.00 last mentioned to $100,000.00 and a reduction of the royalty payable from seven and one-half percent to five and one-half percent.

XI.

The amendment of February 28, 1962, was by letter (Ex. 54) which provided that the rights be transferred at no additional cost. However, on March 6, 1962, an internal Cubic memo (attached to Ex. 54) indicates that a consideration of $75,000.00 had been agreed upon but that the French government had refused to approve the payment. There is a cryptic reference to debiting the CdC special fund in the amount of $75,000.00. The explanation of the special fund is that in the sales agreement of June, 1960, (Ex. 45) CdC purchased $85,324.00 worth of spare parts, some of which it did not use.

XII.

Cubic reported the $200,000.00 mentioned in finding No. VIII, the $100,000.00 mentioned in finding No. X, and the $75,000.00 mentioned in finding No. XI, and the royalties (due in the amount of seven and one-half percent which was later, as indicated, reduced to five and one-half percent) mentioned in findings Nos. VIII and X as long-term capital gains.

XIII.

As a part of the sale of the extremely sophisticated AME and DME equipment it would be necessary and it is industry practice to divulge to the purchaser operational "know how." The divulgence of the operational "know how" would not, however, enable the purchaser to manufacture

the equipment. Any income attributable to the passing on of operational "know how" would be ordinary income.

XIV.

As a fact or as a mixed question of law and fact I find from the general nature of the plaintiff's business, from the infrequency of the transfers of manufacturing and selling rights, and from the relatively small percentage of income received from such transfers that the design and patent rights and the manufacturing "know how" were neither stock in trade nor property which would be included in an inventory or held primarily for sale to customers in the ordinary course of trade or business.

XV.

I adopt as the findings of the Court the facts contained in subparagraphs 1 to 27 inclusive of paragraph 3 of the pretrial order.

CONCLUSIONS OF LAW

The following are my conclusions of law:

I assume for the purposes of this opinion that Cubic had property rights by reason either of its technical manufacturing "know how" or its patents or a combination of both and that some portion of those rights was transferred to CdC. Given this assumption, then by reason of finding No. XIV the property transferred was a capital asset and the problem which remains is whether the transaction amounted to a sale or was simply a license the payment for which would be ordinary income.

The test, whether the transfer was of patent rights or property rights akin to patent rights or [illegible] stantial rights sold?

As indicated in finding No. VI, rights in the United States remained with Cubic. The patents and any patent registrations were to be in Cubic's name. tured items had to bear the notation that they were manu factured under license from Cubic.

CdC was not in so many words prohibited from assign ing or subletting its manufacturing rights to the territory, but in view of the restrictions on the use and reproduction of technical data and the obligation to keep all technical data confidential, it is highly questionable whether an assignment or sublease might have been made without violating the conditions of the agreement. For breach of contract by CdC the contract was terminable. Under the *force majeure* provisions of the contract termi nation could result without any fault on the part of CdC. In the event of termination CdC would have been obligated to return all technical data to Cubic.

I conclude from all of this that there was a transfer of something less than all of the substantial rights and that the commissioner correctly determined that the amounts mentioned in finding No. XII should be taxed to plaintiff as ordinary income.

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[1] *See Schmitt v. Commissioner*, 275 F. 2d 850, 853 (3d Cir. 1960); *E. I. duPont de Nemours & Co. v. United States*, 288 F. Supp. 926 (D. Del 1968) *aff'd* 432 F. 2d 1052 (3d Cir. 1970).

[2] *See Pickren v. United States*, 378 F. 2d 595, 601 (5th Cir. 1967); *C. A. Norgren Co. v. United States*, 246 F. Supp. 759, 763 (D. Colo. 1967).

The defendant will prepare a judgment in conformity with these findings.

DATED this 22nd day of September, 1971.

/s/ Russell E. Smith

RUSSELL E. SMITH
United States District Judge

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

CUBIC CORPORATION, a California corporation, *Plaintiff,* vs. UNITED STATES OF AMERICA, *Defendant.*	Civil No. 67-61-S JUDGMENT

The Court, having filed its findings of fact and conclusions of law on September 27, 1971, with respect to the only issue between the parties for the years 1960 to 1963, inclusive, and the parties having entered into a stipulation as to settlement of all other issues raised in the complaint for those years, it is in conformity therewith.

ORDERED, ADJUDGED and DECREED that plaintiff's complaint and action for the years 1960 to 1963, inclusive, be dismissed on the merits, and that defendant be allowed its costs of the action.

DONE at Missoula, Montana, this 17th day of December, 1971.

/s/ Russell E. Smith

RUSSELL E. SMITH
United States District Judge

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-42

CUBIC CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question raised by the petition is whether the courts below correctly held petitioner to have realized ordinary income, rather than capital gains, under particular terms of a licensing agreement it entered into with a French company.

Petitioner is engaged in the development, manufacture, and marketing of equipment used to enable ground stations to track the position of objects in space. Although this equipment has potential for commercial uses, nearly 90 percent of petitioner's business has been with Federal agencies of the United States in the world-wide tracking system the National Aeronautics and Space Administration (NASA) established for its Project Mercury (Pet. App. A 1a-2a, Pet. App. B 1b; Ex. B, p. 5; Ex. C, p. 3).

In 1958, the French Government became interested in obtaining some of petitioner's equipment for the instrumentation of its missile range in Algeria. However, French officials deemed it important that a French concern be involved in the venture. Accordingly, they suggested that petitioner should also enter into some form of licensing agreement with technically qualified French businesses. After extensive negotiations, petitioner entered into such an arrangement with Compagnie des Compteurs (CdC) (Pet. App. B2b). The agreement provided that petitioner would supply CdC with the designs and know-how required to manufacture its equipment. While there were no foreign patents with respect to petitioner's equipment, petitioner granted CdC the exclusive right to sell and distribute certain items of its equipment within specified countries and a nonexclusive right to sell these items in others (Pet. App. B 2b-3b).

In the agreement, petitioner specifically reserved "the right to conduct business with all agencies of the United States Government in all parts of the world for any reason." CdC was required to "obtain prior authority" from petitioner before even making an offer to supply equipment to the United States for anything other than "Off Shore Funds." On labels attached to all the equipment CdC manufactured, it was required to identify itself as petitioner's "licensee." While the contract severely limited CdC's rights to release data and know-how pertaining to the licensed designs, it imposed no reciprocal restraints against petitioner's rights to release this unpatented data and know-how. Finally, CdC was prohibited from assigning its rights under the contract without petitioner's prior written approval (Pet. App. B 4b-5b, 9b; Ex. 34).

The contract provided for an initial payment by CdC of $275,000 and the further payment of a royalty upon

equipment manufactured under the agreement. Petitioner, however, agreed to accept $200,000 in lieu of the $275,000 initial payment if CdC ordered $700,000 of equipment from petitioner. CdC thereupon made an order of sufficient magnitude to meet that condition (Pet. App. B 6b).

The parties modifed the contract three times during the succeeding years, to grant CdC the right to manufacture and distribute more of petitioner's equipment,[1] to reduce the royalties under the licensing arrangement and to increase the area of CdC's "exclusive" territory. As consideration for these amendments, petitioner received an additional $175,000 (Pet. App. B 6b-7b).

Petitioner reported the entire $375,000 it received from CdC as capital gains. On audit, the Commissioner of Internal Revenue determined that this income was taxable as ordinary income and accordingly assessed a deficiency. In a refund suit brought by petitioner, both the district court and the court of appeals upheld the Commissioner's determination on the ground that petitioner had not conveyed all substantial rights to CdC under the agreement (Pet. App. A 1a-2a, Pet. App. B 1b-11b).

1. It is well established that consideration received for the transfer of unpatented rights and processes is not taxable at capital gains rates unless "all substantial rights" to those rights and processes are conveyed. See *e.g., Taylor-Winfield Corp.* v. *Commissioner*, 467 F. 2d 483 (C.A. 6), affirming 57 T.C. 205; *Pickren* v. *United States*, 378 F. 2d 595 (C.A. 5); *Bell Intercontinetnal Corp.* v. *United States*, 381 F. 2d 1004 (Ct. Cl.); *E.I. Du Pont de Nemours and Co.* v. *United States*, 288 F. 2d 904 (Ct. Cl.). Indeed, petitioner acknowledges (Pet. 8-17) the applicability of this rule. However, it challenges the decision below that it had conveyed less than "all substantial rights" in its contract with CdC.

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[1]Such additional equipment included that used by NASA in tracking its Project Mercury astronauts (Pet. App. A 2a; Ex. B, p. 5).

Petitioner first asserts (Pet. 7-12) that its reservation of the right to do business with the United States did nothing more than recognize the United States' preexisting rights to its equipment. It urges that because some of its equipment was designed under government research and development contracts, the United States was entitled to royalty-free access to those designs. Therefore, it contends, its reservation of the right to do business with the United States even in CdC's "exclusive" territory only gives contractual recognition to the United States' preexisting rights.

While a transferor's failure to convey such preexisting rights has, on occasion, been deemed not to alter the capital character of the transaction (*Bell Intercontinental Corp.* v. *United States*, *supra*; *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); cf. *General Aniline & Film Corp.* v. *Commissioner*, 139 F. 2d 759 (C.A. 2)), this case does not fit within the mold of those decisions which hold on their facts that all substantial rights were transferred. There is nothing in the record which demonstrates that the United States government had rights in all of the equipment covered by the license agreement. While the government's involvement in the initial development of certain of petitioner's equipment might have given it some rights in the resulting designs (II-R. 19-20),[2] the evidence showed that petitioner had made improvements to these designs over the years (II-R. 46).

The extent to which these design improvements were covered by the government's royalty-free license was never defined. It was stipulated that certain of the designs transferred to CdC were developed by petitioner, apparently without government assistance (I-R. 73). With respect to those designs, no rights would ever have

[2] "I-R." and "II-R." references are to volumes one and two of the duplicated record in the court of appeals.

vested in the government. Moreover, whatever rights the federal government possessed could have been fully protected by petitioner's waiver of all royalties on equipment produced by CdC for the United States government. That petitioner chose instead to reserve for itself all business with the United States shows that petitioner intended to and did convey less than all substantial rights in the designs and know-how to CdC. The cases cited by petitioner (Pet. 8-9) as conflicting with the decision below are distinguishable on account of petitioner's reservation of substantial rights.

2. Contrary to petitioner's further argument (Pet. 12-15), the decision below did not look outside the territory exclusively granted to CdC in concluding that not all substantial rights were transferred. Indeed, even the territory granted CdC was hardly "exclusive" in light of the well-known international scope of United States' space programs. The possibility of federal activity within the territory "exclusively" granted CdC could hardly be called remote.[3] Petitioner's equipment, rights to which it transferred to CdC,[4] had been used by NASA in what petitioner described as a "globe-girdling" network of tracking stations[5] (Ex. E, p. 6). Thus, it was clear to both courts below that even within the "exclusive" territory granted to CdC, petitioner's reserved rights were substantial.

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[3]In the end, the so-called "exclusive" territory encompassed nearly all of Europe and the Middle East (Pet. App. B 6b; Ex. 64).

[4]Petitioner's statement that the equipment used in Project Mercury was not sold in the 1960 agreement is misleading. This equipment, known as the AGAVE system (Ex. C, p. 6; Ex. D, pp. 1, 6), was included in the licensing agreement in a subsequent amendment (Ex. 54).

[5]Petitioner asserts (Pet. 5, 14-15) that the licensing provision authorizing CdC to compete for governmental business that was to be transacted with "Off Shore Funds" effectively meant that CdC could compete for all United States procurements abroad. This interpretation of the licensing agreement is not warranted by its

Nor was there a need to look to anything other than the economic value of this reservation. Agencies of the federal government were petitioner's chief customers, accounting for nearly 90 percent of its business (Ex. B, p. 5; Ex. C, p. 3). The government's involvement in activities abroad gave the threat of foreign competition real substance. Petitioner accordingly drafted the reservation clause in order to meet this challenge of foreign competition. It included, first, an unqualified reservation of United States business, then required CdC to obtain prior authority for any United States business it might choose to seek (in apparent violation of the prior reservation), and finally required notification from CdC of the imminence of CdC's doing business with the government. Petitioner thus had a triple check on CdC. In seeking to

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terms. Petitioner specifically authorized CdC to compete freely only for those United States programs which were funded with "Off Shore Funds" (Ex. 34, pp. 2-3). While funds appropriated for Department of Defense procurement may be expended abroad (see Pasley, *Offshore Procurement*, 18 Military L. Rev. 55, 59 (1962)), these general procurement funds do not fall precisely within the description "Off Shore Funds." The federal government does, however, hold excess foreign currency, which can only be expended abroad. *E.g.*, Act of August 26, 1954, c. 937, 68 Stat. 832, Section 502 (22 U.S.C. 1754); Act for International Development of 1961, 75 Stat. 424, Section 612 (22 U.S.C. 2362). These funds come much closer to meeting the classification of "Off Shore Funds" than do general procurement funds, for they are irrevocably "Off Shore." But as a domestic corporation, petitioner could not have competed for these foreign funds in its own rights and therefore gave nothing of value to it when it transferred to CdC the right to seek "Off Shore Funds." Indeed, the only way it could profit from procurement made with such funds was through CdC's royalty payments.

have this reservation classified as insubstantial, petitioner has denied the terms of its own contract.[*]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

SEPTEMBER 1974.

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[*]Furthermore, it is apparent on the face of the licensing agreement that petitioner did not grant CdC the control over the release of the unpatented design data and know-how which is essential to its exclusive possession. Absent such a grant, the transaction does not qualify for capital gain treatment. *E. I. duPont de Nemours and Co. v. United States*, 288 F. 2d 904, 912 (Ct. Cl.); *Commissioner of Internal Revenue v. Corn Products Refining Co.*, 350 U.S. 46, 52; *Hygrade Corp. v. Commissioner*, 42 T.C. 455, 468-469.

Moreover, the record demonstrates that petitioner viewed the agreement with CdC simply as a vehicle for increasing its sales of tracking devices (III-R. 183). The resulting income arising from the day-to-day operation of petitioner's business is not entitled to capital gains treatment. *See Corn Products Co. v. Commissioner*, 350 U.S. at